CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 278

November 2, 1964

PATENT ROYALTIES: SALE OR EXCHANGE OF PATENTS

Syllabus:

On November 1, 1948, and February 15, 1951, taxpayer granted to each of two companies the right to manufacture, use, and sell certain patented products in an exclusive and in an nonexclusive territory. The boundaries of each of the four territories were specifically delineated. Payment for the transfer was in an amount measured by a percentage of sales, with a minimum annual provision.

Other provisions of the agreements are not discussed since they appear to have no effect on the conclusions reached herein.

(1) Was there a sale or exchange of patents pursuant to Sections 18192 to 18195, inclusive?

(2) If not, which sections of the Revenue and Taxation Code are applicable?

(1) Sections 18192 through 18195 conform the Personal Income Tax Law to Section 1235 of the Internal Revenue Code of 1954 as amended. An essential requirement precedent to application of these sections, however, is the transfer of all substantial rights to the patent or an undivided interest in all such rights.

This requirement is not met when the transferee's rights are limited geographically. Reg. 18192-18195(b)(3); 3 U.S. Cong. News 1954 at 5082. Since each of the agreements with which we are concerned, affirmatively provides for a geographical limitation, it is concluded that Sections 18192 to 18195, inclusive, are inapplicable.

(2) One legal text writer suggests that failure to qualify as a Section 1235 transaction precludes royalty-type payments from receiving capital gain treatment. Mertens, Sec. 22.134. This conclusion, however, appears to be an extension of Congressional intent beyond that expressed. The regulations clearly provide that a transaction failing to qualify under Section 1235 must be tested by other statutory provisions and judicial decisions to determine whether the capital gain provisions apply. Reg. 1.1235-1(b), 3 U.S. Cong. News 1954 at 5084.

Before the statutory provisions permitting capital gain treatment are applicable, the licensor must have been an amateur as distinguished from a

professional inventor, i.e., one involved in recurring transactions. In the absence of evidence here indicating a professional status, it is recommended that taxpayer be considered an amateur.

The courts adhere to the rule that royalty proceeds from a nonexclusive license limited geographically are ordinary income. Vincent A. Marco, 25 T.C. 544 (1955); See also Schmitt, Jr., v. Commissioner, 4 AFTR 2d 5681 (1959) approved without comment in Pigeon Hole Parking, Inc. v. U.S.,7 AFTR 2d 874 (1961). To the extent this role is applicable, it is recommended that ordinary income treatment be applied.

It is appropriate to interpret a patent license agreement as constituting a license in one designated area and an assignment of substantially all the patent rights in another. Merck & Co. v. Smith, 155 F. Supp. 843 (1957). See also Moberg, 35 TC No. 89 (2/24/61). Where the transfer document, in its entirety, evidences an intent to transfer substantially all rights to the patent in a designated area, the proceeds are entitled to capital gain treatment. Such intent is consistent with payment measured by a percentage of sales, Edward C. Myers, 6 TC 258 (1946). Wing v. Commissioner, 5 AFTR 2d 1561 (1960). See also Waterman v. Mckenzie, 138 U.S. 252 (1891). Accordingly, it is recommended that proceeds from the exclusive territories receive capital gain treatment.

It is noted that each agreement provides that a portion of the proceeds are to be paid to various individuals with taxpayer reserving the right to vary the amount of these payments by notice to the transferees, including the amount that his coinventor is to receive.

This reservation suggests a possible assignment of income question. When an inventor assigns only the income, retaining substantial rights in or otherwise controlling the royalty contract, all the income may be taxable to the assignor. Sunnen v. Commissioner, 333 U.S. 591 (1948); Blair v. Commissioner, 300 U.S. 5 (1937); Heim v. Fitzpatrick, 3 AFTR 2d 558 (1959).